

August 26, 1981

LETTER 816

Aug. 14, DJIA 936.93; PTI 1491; A-D Ratio -19.13

Aug. 21, DJIA 920.57; PTI 1472; A-D Ratio -20.16

THE MARKET: (1) On August 21 the bear market was re-confirmed as the D-J Industrial and Transportation Averages broke below their preceding lows of 924.66 and 398.71. The fact that the Averages broke simultaneously added authority to the move.

(2) On the chart below note that the Dow has now sunk decisively below its 200-day moving average. This has not happened since February, 1980.

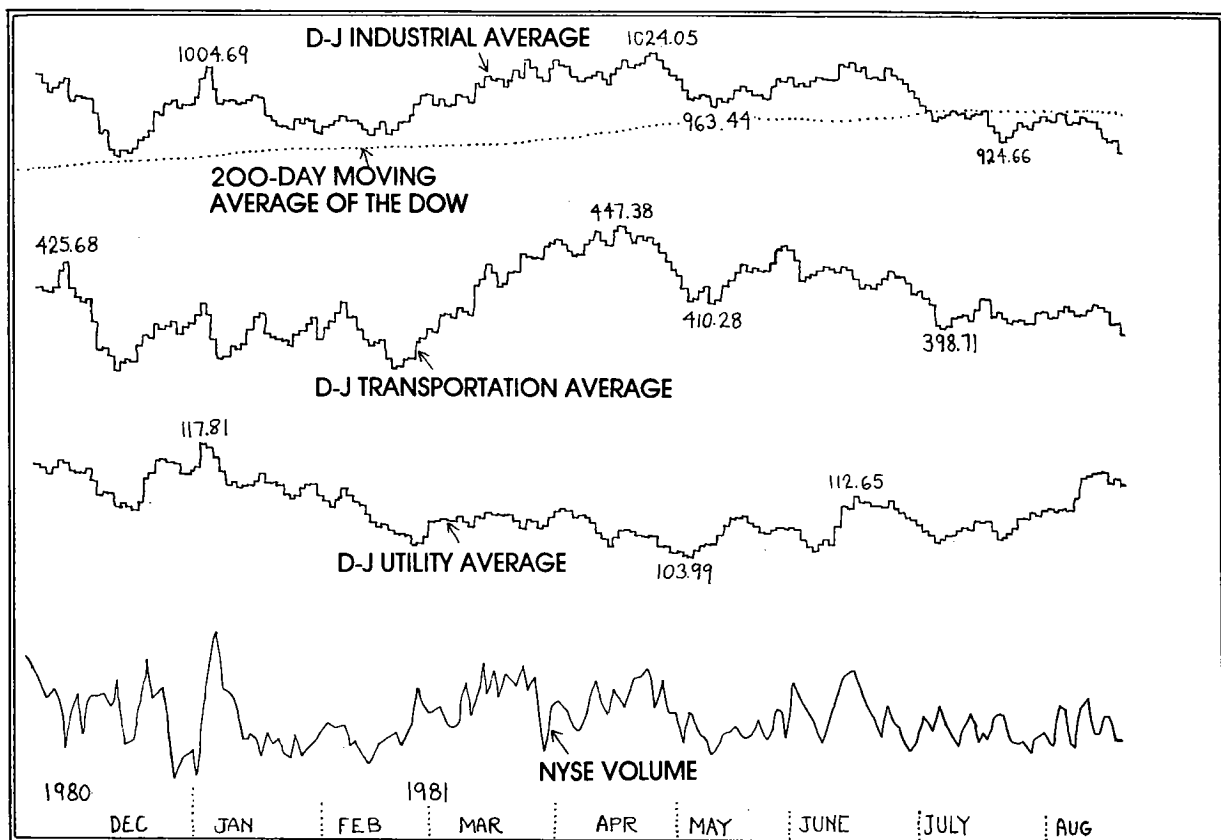
(3) The unprecedented divergence between the D-J Industrial and its own daily advance-decline continues. This extraordinary divergence is over one-year old, and the Dow A-D line (see chart page 2) is now back in the 325 area. The last time the Dow A-D line was in the 325 area the Dow itself was in the 760-780 zone. Thus, technically, the Dow is over 150 points above its A-D line's value.

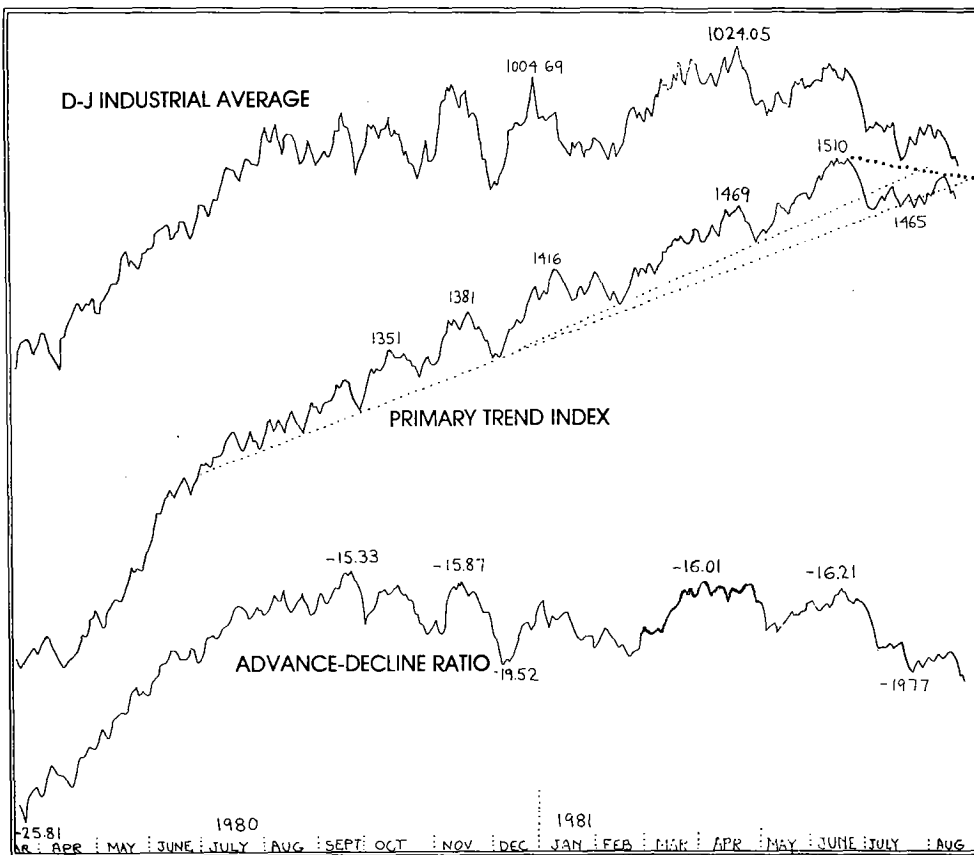
(4) On page 3 I have included a chart of the daily unweighted price average of all NYSE common stocks (charts by *Trade Levels*, 21242 Ventura Blvd., Woodland Hills, CA 91364). Here we see a large and well-defined "head-and-shoulders top" in the average with the "neckline" or support area slanting downward (bearish) and practically meeting the 39-week moving average. I consider this a most important chart, and one implying that the market has been under intense and systematic distribution since March of this year.

FRONT PAGE COMMENT: The extraordinary Reagan tax bill is now law. The new tax bill is going to produce a projected \$280 billion loss in Federal tax revenue. With an Administration promise of a balanced budget in 1984, massive new budget cuts will have to be engineered. Stated President Reagan, "The fight to control the Federal budget is just beginning." The fact is that the easy cuts have all been made. With a promise of a 7% a year (after inflation) rise in military spending, the coming budget slashes will have to be huge. Whole departments will have to be eliminated. Sacred cows will have to be slaughtered.

Informed sources are now predicting that the 1982 budget deficit could go over \$60 billion (interest rate costs have added \$20 billion to the 1982 estimates). The House Budget Committee now predicts a \$61 billion deficit for 1984. And I predict that President Reagan is going to make an agonizing reappraisal regarding his whole budget.

Without a doubt President Reagan has the very best of intentions. But there is no way that taxes can be cut, military spending can be accelerated and the budget balanced. Last week the GNMA futures contracts hit historic lows while the municipal bond market literally fell apart. The money markets are preparing for the blood bath as the US Government takes on all comers for new money.



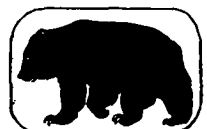


(5) Turning to the PTI, note on the page 2 chart that the PTI, after bobbing just above and just below the major rising trendline for over a month, broke (on August 21) decisively **BELOW** that major rising trendline. I have now drawn a *descending* trendline over the PTI starting with the June 23 peak of 1510. As long as the PTI holds below this descending trendline, the PTI will be in a bearish mode. Thus the PTI has now confirmed the primary Dow Theory bear signal of July 2.

(6) I have plotted the advance-decline ratio for the NYSE at the bottom of the above chart. On August 21 the A-D broke to a new 1981 low. This action saw the A-D tumble to its lowest level since June of 1980, at which time the Dow was in the 860 area. The action of the A-D ratio indicates that "the rest of the mar-

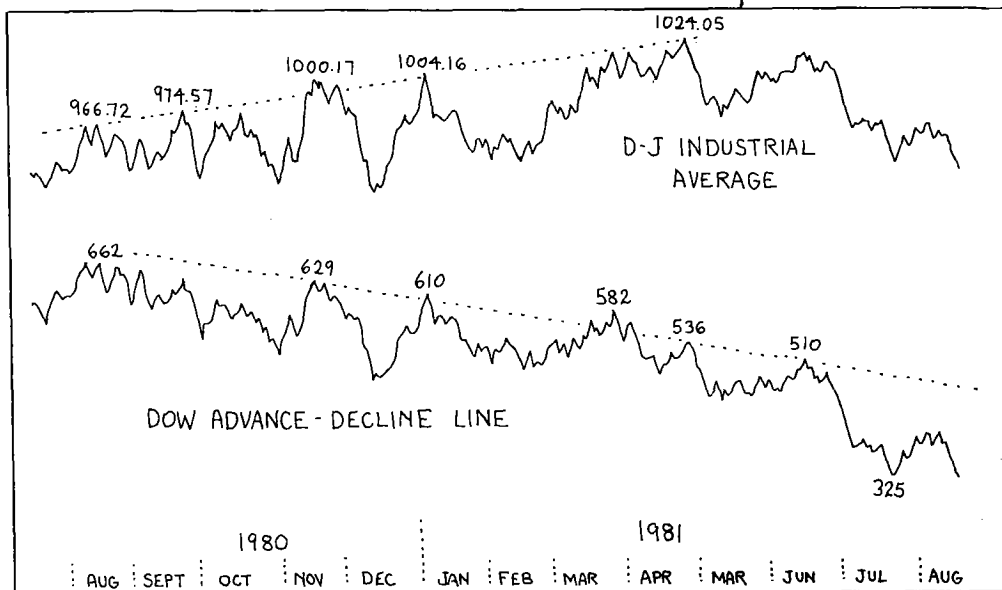
(9) Subscribers should remember that just as a bull market seeks to advance with the fewest number of investors participating, so a bear market attempts to decline while taking the greatest number of stockholders with it. Thus, just as a bull market climbs the proverbial wall of worry, a bear market retreats amid a chorus of hopes and wishes. A perfect example of the latter was seen this year as the bond market smashed in the face of literally hundreds of predictions of "a top in interest rates" (this is still going on, by the way). Conclusion: expect the bear market in stocks to continue in the face of endless optimistic predictions.

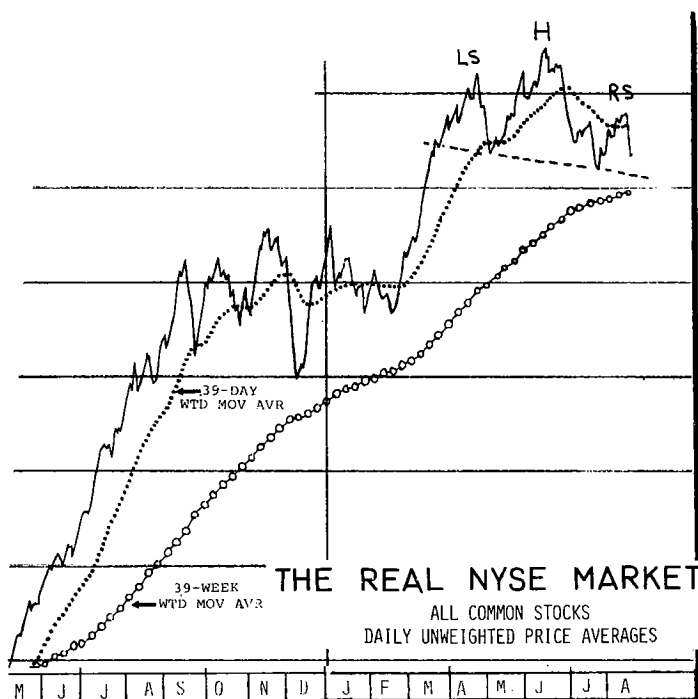
MARKET POSITION: The grizzly still rules this box, and the fact that the PTI is now under its main trendline underscores the bearish stance. The current issue



of *Forbes* lists the 1968-81 performance of all the funds. Very, very few of them show an average annual return of as much as 10%. The T-bills now yield over 15%. I continue to recommend T-bills for all subscribers.

Four money market funds can be purchased in lieu of T-bills (all are invested in short-term Government bills and notes). They are *Capital Preservation* (800-982-6150 or outside CA: 800-227-8380); *Fund of Gov't Investors* (collect 202-861-1810); *Merrill Lynch Gov't Fund* (800-225-1576); *First Variable Rate* (800-424-2444). Patience and accumulation of cash funds should be rewarded over coming months.





PRIMARY TREND INDEX: I've been asked hundreds of times for the formula for the PTI. I have never disclosed the formula. The construction of the PTI is my only market "secret." "Why," people ask, "why keep such a valuable tool a secret?"

It's nice to have smart subscribers, and last week I received this comment from a subscriber in Glendale, California. *"I would like to make the following comment in support of not making the calculations of the PTI public knowledge. There is in modern (since 1900) physics a theory known as the 'uncertainty principle.' One interpretation of its effect is that the more a measuring device interacts with what it is measuring, the less certain one*

is of the measurement. Keeping the calculations of the PTI private will thus restrict the interaction of the PTI with the market, resulting in greater validity of its indications."

Another way of putting this is that when a device becomes too popular, the market starts discounting the device itself. This rule has resulted in the death of many widely-followed indicators and indices, and I don't want the PTI to be one of them.

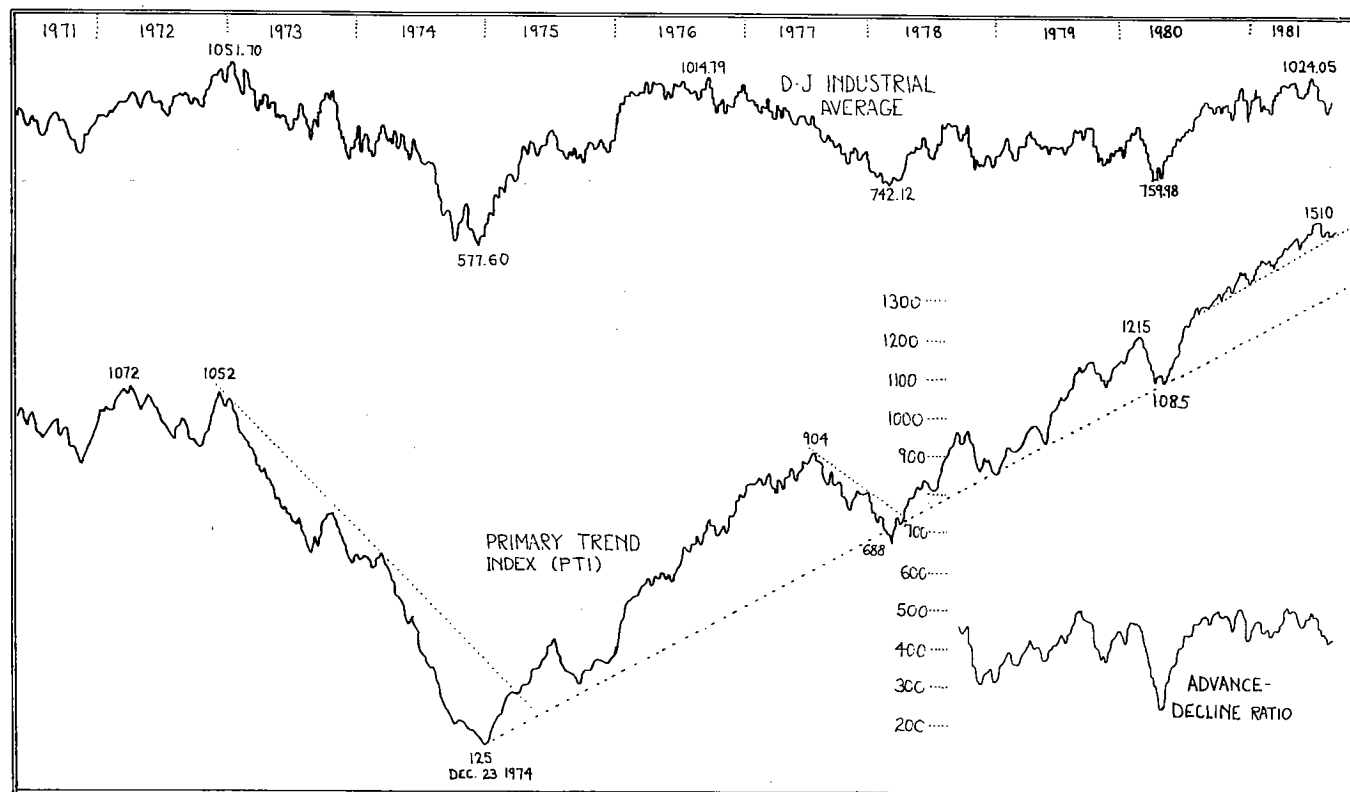
I am including my long-term chart of the PTI, a chart showing the whole history of the PTI going back to mid-1971. Here we see the extraordinary non-confirmation of early-1973, a technical aberration which signalled the beginning of the greatest market smash since the 1930's.

The PTI bottomed at 125 on December 23, 1974. From there it mounted an incredible rise to 904 in 1977. A sharp break brought the PTI down to 688 in early-1978, followed by a new advance to 1215 in early-1980. Another break took the PTI to 1085 in early-1980, and again the PTI led the way to higher ground.

The high was recorded on June 23, 1981 at 1510, and that high still stands. The question: will the PTI burst through its 1510 peak or will it break under its last low at 1465? If the 1465 low is broken, the PTI will have violated a trendline that has held intact for well over a year.

One of the valuable facets of the PTI, and you can see this on the chart, is that it tends to follow trendlines extremely well. It tends to respect trendlines, and when a PTI trendline is broken, that violation usually is significant. This trendline analysis of the PTI is particularly helpful during the present period, a period when the leading averages have been difficult to follow, often deceptive and prone to whip-saws.

This long-term chart of the PTI is of real use when viewing the market from the very long or super-cycle standpoint. I have drawn a trendline connecting the 1974 and 1978 bottoms. This trendline has held intact for a remarkable seven years, and you can see that it would take a major smash from the current



level to violate this super-trendline. Now that the 1980-81 trendline has been violated, we will watch the even larger trendline which began at the bear market low of December 23, 1974.

MONEY: Question: Russell, how safe are the money market funds? I get an uneasy feeling when I see the total of these funds moving towards the \$150 billion mark.

Answer: The money funds (like gold during 1978-80) are moving in an exponential rise that will soon reach the perpendicular. Now we know that this cannot go on for long, since such a rise, if it continues, will suck up all the money on the face of the earth. If we study history we note that all exponential rises ultimately end — and they often end with a plunge that tends to resemble (in reverse) the preceding rise.

Question: We know that the specter of disinflation set off the 1980-1981 collapse in gold. What could bring on a comparable collapse in the money market funds' explosive build-up?

Answer: Most of the money market funds hold commercial paper, and some hold almost 100% commercial paper. If I had to guess I would say that the rise in the money market funds will end when some kind of trouble hits the commercial paper market. Of course a great deal of bank C/D paper is also held by the MM funds, but I'm more worried about the commercial paper. About 60% of the current \$145 billion in MM funds is now invested in both commercial paper and bank C/D paper. Only a minor part of the C/D paper is insured and none of the commercial paper is insured.

In view of the foregoing, I believe the utmost safety is warranted. And that, in my opinion, is the T-bills. If you can avoid potential trouble, it just makes good sense to do so.

Question: What part do you think the money market funds are playing in the whole investment scene today?

Answer: They're playing a huge part. The public is now being squeezed by high costs and the need for more cash to meet their bills. In short, the public needs INCOME! This is where the funds with their 15% to 17% yields come in. The funds are proving to be an irresistible attraction to the public. Money is coming out of the stock market, out of the long-term bond market, out of commodities, out of the walls — and going into the money market funds.

All of which leads us to the next section, the comparison of stock yields and debt yields. Study the dramatic charts in the next section, and you will see why we are now witnessing a revolution in the investing habits of the American public.

I've been warning of this for over two years, and here it is, right in your *WSJ*. Late note: now we learn that the Treasury will be borrowing \$2 billion a week right through October.

**THE WALL STREET JOURNAL,
Friday, August 21, 1981**

NEW YORK—The government's borrowing costs continued to climb to record levels and bond prices fell again yesterday amid growing investor skepticism about the administration's economic program.

The Treasury yesterday had to offer investors a record average return of

16.26% to sell \$4.75 billion of two-year notes. That easily surpassed the previous record average return of 15.92% set on a two-year note issue July 22.

The Treasury's huge borrowing needs to offset government deficits have been occupying center stage in the jittery credit markets, helping to propel interest rates sharply higher. Many financial experts contend that the administration has grossly underestimated the size of its deficit for fiscal 1982, which begins Oct. 1, and that the Treasury will be forced to borrow even more than expected.

Henry Kaufman, chief economist of Salomon Brothers, argues that the government's economic policies will be especially troublesome for the badly battered municipal bond markets.

In a strongly worded report released yesterday, Mr. Kaufman predicted that yields on municipal securities, which already are

at record levels, will climb even higher. He warned that state and local governments won't be able to compete with the enormous credit demands of the U.S. government and large business corporations.

Credit Markets

THE PICTURE: Recently a subscriber asked me what I thought the most pressing problem currently facing the market was. I immediately answered, "The biggest problem facing the market today is how the US Government is going to finance its deficits. In making its budget estimates, the Administration could have made three broad miscalculations: (1) They may have estimated business and therefore tax collections to be better in 1982-83 than it actually will be. (2) They may have underestimated the shortfall in tax receipts that will result from the sweeping tax cuts. (3) They most definitely have underestimated the cost to the Government of high interest rates."

None of these possible miscalculations have been lost on the money markets. The result is continued pressure on bonds, notes and bills and a continued high level of interest rates. This produces a "dog eating its own tail" syndrome. If interest rates stay high, business (particularly housing and autos) must be adversely affected. If business slows, profits will decline and tax receipts to the Government will dwindle. Dwindling tax receipts mean more deficit financing and greater deficits, and these in turn keep interest rates high.

This round-robin, to my mind, is the great danger in the current financial scene. The question to come out of all this, as I stated in the beginning, is "How is the Government going to finance the coming huge deficits?" If the Treasury simply sells more bills, notes and bonds they will crush the money markets. If the Fed monetizes new Treasury debt, this process is inflationary, and the money market will protect itself by sagging further (thereby pushing up yields).

What is the plus side, the hope in the situation? The thin hope is that somehow the deficits will be smaller than expected or the markets somehow will not be upset by the deficits. In the meantime, however, I feel that with each month that goes by accompanied by high interest rates (for instance, 91-day bills of over 14%) the odds increase that trouble is on the way.

Question: What stance do we as investors take in all this?

Answer: We stay mainly in 91-day T-bills. As I've said before, this is picnic time for people who possess cash. The day of the saver and the lender has arrived.

Question: Does all this have anything to do with gold?

Answer: Yes, gold suspects that there is going to be large deficit financing ahead. Obviously, such financing would amount to a dilution of the dollar, and diluted dollars are worth less in terms of gold.

NOTES & QUOTES: The world population is now at a record 4.5 billion (it was 2 billion when I was a boy). The highest birth rate nations are now all in Africa with Niger first (51.4 births per 1,000), Malawi with 51.1 per 1,000. Kenya with 50.8, Ethiopia with 49.9, Nigeria at 49.8, Liberia at 49.7. Lowest rates are W. Germany with 9.8, Switzerland with 11.5, Sweden with 11.8, Britain with 12.0. The US is at 15.2.

The most populous nations are now China with 985 million people, India with 688 million, Russia with 268 million, US with 229 million, Indonesia with 149 million, Brazil with 121 million.

The largest urban areas are New York-NE New Jersey with 20 million, Tokyo-Yokohama with 20 million, Mexico City with 15 million, Sao Paulo with 13.5 million, Shanghai with 13.4 million.

Conclusion: the food business may or may not make money but it's going to be awfully busy in the foreseeable future. Second conclusion: birth control MUST come to Africa and S. America.

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Utility Strength: It may stem from this An obscure provision of the new tax law permits public utility shareholders to deduct \$750 in dividends IF they take those dividends in the form of more stock instead of cash! This is another example of Government giving goodies to weak industries in an effort to keep them afloat. Another example: the phoney new accounting methods by which S&L's are allowed to spread out their losses over a number of years. Imagine you and me going bankrupt but being allowed to spread out our losses over years (under this system, nothing and nobody ever goes broke, we just wither away!).

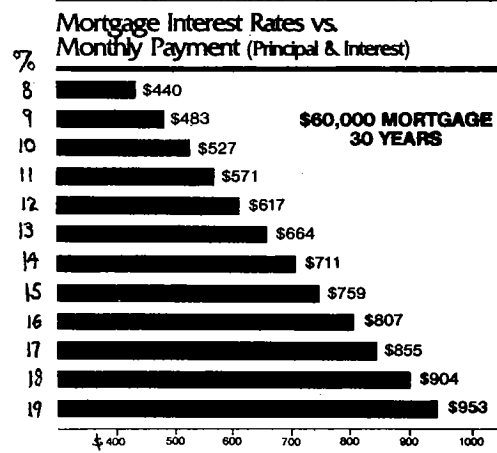
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What's the test of efficiency in living matter. Why, it's the number of individuals that survive. There are 4.5 billion people on the earth. But there are 100 billion birds on this planet. Now, are you ready for this: there are 700,000 *species* of insects on earth, and 1000 new species are discovered each year. The number of insects on the earth must be calculated in the tens of trillions!

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From our "Lessons in Compound Interest Dept.": A couple buying a \$70,000 home who have put down a standard 25% and financed the remaining \$52,000 mortgage over 25 years would have a monthly interest and principle payment of \$755. The couple would end up paying out \$244,000. Of the total amount paid out, \$174,000 would have gone for interest alone!

This interesting chart shows how montly payment on a \$60,000 thirty year mortgage would change with interest rates.



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The widely-read *Popular Mechanics* magazine recently did a detailed study with actual tests on the leading compact cars of the world. I include here their conclusions.

What we learned

Lesson One: The Japanese are the leaders in small cars—and with good reason. Their cars are generally better built, better engineered, better styled, more nicely appointed and lower priced than the competition. That's a combination that's hard to beat. Our test group uniformly preferred the cars from Japan.

Lesson Two: The idea that American drivers prefer cars with a soft ride and mushy handling is a myth. Our typical American testers uniformly preferred the cars which had the tautest, most "European" handling.

Lesson Three: Good tires can mask a multitude of suspension woes. The Toyota Tercel's basically good chassis was undermined by terrible tires; the Mercury Lynx's basically terrible suspension was made acceptable, if not perfect, by fitting high-performance Michelin XZX tires.

Lesson Four: For most people, the best of these small economy cars will perform every function that they require from an automobile, without compromise. These cars are completely competitive, even when compared with much larger machines that cost much more.

Lesson Five: The American car companies are in trouble not because of any outside forces, but through their own fault. Police chief Louis Washington put it best. "I'm an American," he said. "I'm a veteran and an old-fashioned patriot. I want to like American cars, but in good conscience, I can't bring myself to recommend them. They simply aren't as good." And that is the most important lesson of this road test. Let's hope that Detroit learns it before it's too late.

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How broke can you get? Western bankers take note.

Poland is so short of hard money that it was unable to pay for and take delivery of its latest order of Polish paper currency, which is printed in London.

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Thought of the Week: Only 10 of the 50 states in the USA now have AAA-rated bond credit.

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The current issue of *Forbes* magazine lists all the funds' performances from 1968 through 1981. Very, very FEW of these funds have shown a total return of as much as 10%. But you can buy T-bills and get over 15% on your money. Does that tell you something?

The *New Yorker's* cartoonists often have a gift for making fun of our current obsessions. Here's a cartoon that I got a laugh over.



"It's a novel about interest rates."

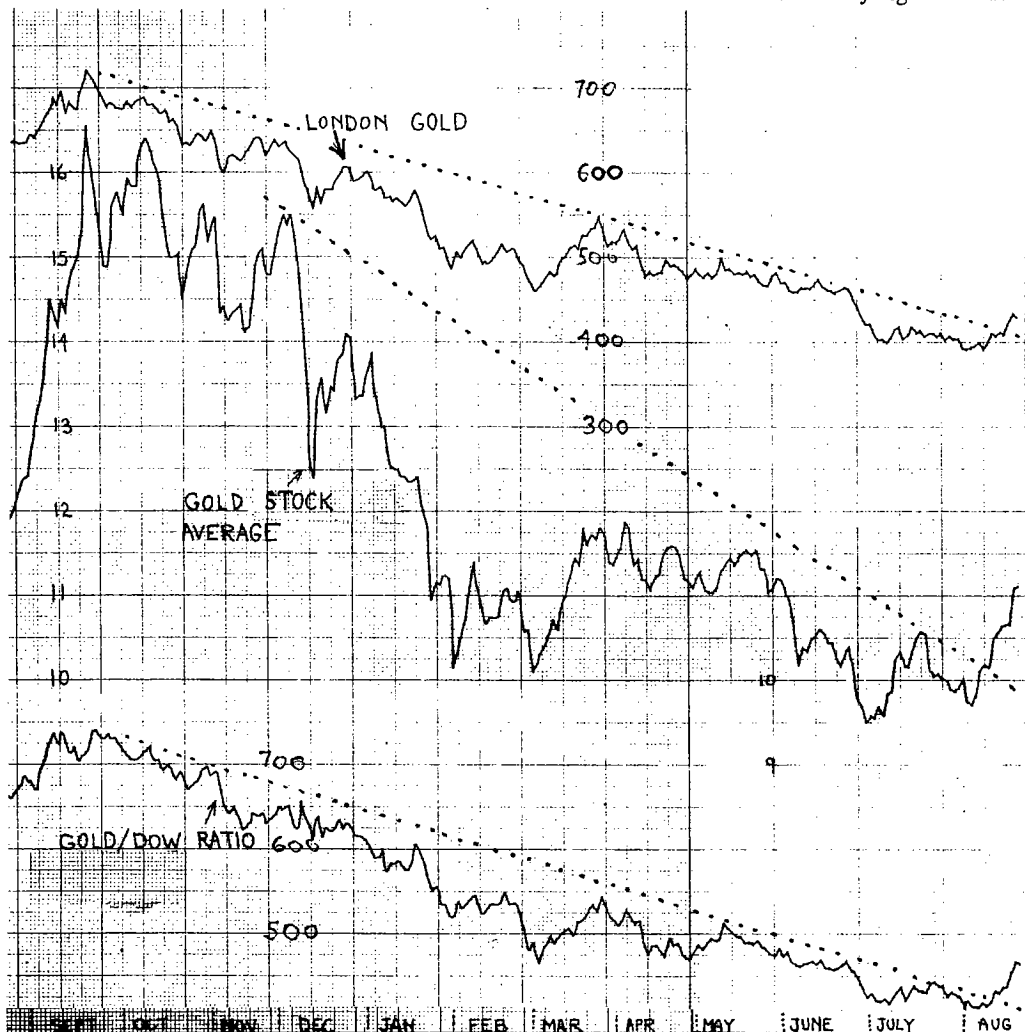
The 1981 (Nov. 18-22) New Orleans conference really looks like the best conference I've ever seen. New formats, new faces, and a

parade of top names in the industry including a rare appearance Ayn Rand, the famous philosopher and writer ("The Fountain-head," "Atlas Shrugged"). I'll be speaking there, but I'd go to this one even if I wasn't speaking. More on the conference later, but call now for a brochure at 504-456-0040. Early signers get discount prices (by the way, I take no commission or fee of any kind if you sign, I'm just enthusiastic about this Conference).

GOLD: Is this the real thing? Have we seen the bottom for gold? I'd say the chances are *better* than even that we have. The daily chart shows three criteria I keep for gauging gold. All three have reversed to the upside. The top line shows the daily London fix, and last week this turned positive as bullion bettered a 12-month declining trendline. The same can be said of the gold share average, and by the way I note that the short interest in ASA almost doubled in the latest reading (too many bears?).

At the bottom of the chart please note the Dow/gold ratio (daily gold fixing divided by the closing Dow price). This climbing Dow/gold ratio is a must if gold is going to advance, and I distrust any gold rally which is not accompanied by a climbing Dow/gold ratio.

The 5-week moving average (MA) for gold is now at 413, the 13-week MA is at 427 and the long-term or 50-week MA is at 494. Spot London gold is now holding above not only the 5-week but the 13-week MA. If it can remain above the 425-430 area, such action will be impressive. And it will mean that in a few weeks the 5-week MA will climb above the 13-week MA, thereby giving a first "buy signal" under the moving average study.



LATE NOTES: Now that losses are sprinkling the portfolios, a few people are (belatedly) calling me and asking "Should I sell?" I tell them that I always follow correct investment procedure. When a Dow Theory bear signal is given and when the PTI is in a downtrend, you hold stocks at your own risk. "If it is to be a mild bear market," I tell them, "you might not sustain severe losses. But if the bear market is fated to be a whopper, then you'll wish to heaven that you had sold."

"But how bad do you think it will get?" they ask. And I answer that in this business I use my intuition, my experience and whatever brains the good Lord gave me—but I don't have the key to the future and I don't have a working crystal ball. When my studies say "bear market" I believe them, and I act on it. And I have seen enough between July 2 (the day of the bear signal) and August 21 (the confirming PTI bear signal) to raise the "danger flag." What more can I say?

NEXT MAILING: Sept. 10